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No. 82-1980
IN THE

Supreme Court of the United States

October Term, 1982

HELEN SMITH,

Petitioner,

vs.

FRED H. HARMSEN, *et al.*,

Respondents.

SUPPLEMENTAL BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

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Introduction.

On July 1, 1983, this Court issued the decision in *Dirks v. Securities and Exchange Commission*, ___ U.S. ___, 51 U.S.L.W. 5123, which provides additional support for the issues raised in Helen Smith's Petition for Writ of Certiorari. In accordance with Rule 22.6 of this Court's rules, we submit this supplemental brief analysing the direct relevance and impact of the *Dirks* decision to the issues raised in the pending petition.[1]

[1]As provided by Supreme Court Rule 22.5, we are concurrently filing a very limited reply to Respondents' highly misleading and inaccurate opposition to the petition for certiorari. The instant supplemental brief accordingly does not address issues raised in Respondents' opposition, but is limited to analysing the impact of the recent *Dirks* decision.

This Court's Decision in Dirks Re-Confirms That the Requisites for Primary Liability Under § 10(b) and Rule 10b-5 Apply Equally to Causes of Action Premised on Secondary Violations of Securities Law. It Thus Further Compels Reversal of the Court of Appeals' Decision Which Improperly Lowers the Standards for Secondary Liability to the Point That Banks, Law Firms, Accounting Firms, and All Other Third Parties Who May Have Access to Nonpublic Information Will Henceforth Be Exposed to Liability Coextensive With That of the Primary Violator if They Simply Fail to Monitor and Expose Violations of Securities Law by the Stock Issuer.

On July 1, 1983, this Court issued its decision in *Dirks v. Securities and Exchange Commission* which underscores and further validates one of the principal contentions raised in Helen Smith's Petition for Writ of Certiorari, namely, that there can be no secondary liability for aiding and abetting violations of the securities law unless the conduct of the secondary defendant satisfies each of the requisite elements of a cause of action for primary civil liability under § 10(b) and Rule 10b-5.[2] Those elements are: (a) a duty to

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[2]In *Dirks*, there was no need for the Court to address the more basic question raised in our Petition and expressly reserved in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191-192, n.7 (1976), and *Herman & MacLean v. Huddleston*, ___ U.S. ___, 74 L.Ed.2d 548, 553, n.5 (1983), namely, whether civil liability for aiding and abetting even exists under § 10(b) and Rule 10b-5. *Dirks* was a disciplinary proceeding which arose under § 15 of the Securities Exchange Act, 15 U.S.C. § 78o(b)(4)(E). Section 15 expressly authorizes the SEC to impose sanctions against broker-dealers who "willfully aided [or] abetted" violations of the federal securities law. The question in *Dirks* was whether sanctions could be imposed against a broker-dealer for aiding and abetting where the requisite elements of a primary cause of action had not been met. The Court concluded they could not.

disclose in connection with the purchase or sale of securities; (b) breach of this duty with the intent to deceive; (c) causing actual and identifiable damages.

The Court's primary focus in *Dirks* was on the duty requirement. The Court held that absent an underlying fiduciary duty to purchasers or sellers of securities, a broker-dealer who obtains material nonpublic information cannot be held secondarily liable for violating prohibitions against insider trading even if he uses the information for his own benefit or the benefit of his customers. 51 U.S.L.W. at 5126. A duty to disclose arises from an underlying fiduciary relationship and not merely from the possession f material nonpublic information.

The Court's insistence upon a fiduciary relationship to establish a cause of action for a secondary violation of securities law reaffirms the rule articulated in *Chiarella v. United States*, 445 U.S. 222 (1980), a case of primary responsibility. There, the Court ruled that absent such relationship, an individual who trades on inside information does not violate any provisions of securities law. Any other result would "depar[t] radically from the established doctrine that duty arises from a specific relationship between two parties. . . ." *Chiarella, supra*, at 233. In *Chiarella*, in other words, the Court recognized that the disclosure duties imposed by § 10(b) and Rule 10b-5 do not apply across the board. They govern the conduct of fiduciaries; they do not govern the conduct of others. See *Walton v. Morgan Stanley & Co.*, 623 F.2d 796 (2d Cir. 1980).

In *Dirks*, the Court ruled that the same principles apply to secondary violations of securities law. Absent a duty to disclose arising from the relationship between the parties to the transaction, a broker-dealer cannot be held liable for aiding and abetting violations of insider trading rules by failing to disclose material nonpublic information.

> "[T]here can be no duty to disclose where the person who has traded on inside information 'was not [the corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.' [*Chiarella, supra*], 445 U.S., at 232.
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> * * *
>
> "We reaffirm today that '[a] duty [to disclose] arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market.' 445 U.S., at 232-233, n.14." 51 U.S.L.W. at 5125, 5126.

In addition to breach of duty, the Court held that there must also be evidence that investors were in fact defrauded or deceived by the alleged misconduct: "[T]o constitute a violation of Rule 10b-5, there must be fraud." 51 U.S.L.W. at 5128, n.27. Moreover, the Court reiterated that scienter is an independent element of a Rule 10b-5 violation.

> "It is not enough that an insider's conduct results in harm to investors; rather, a violation may be found only where there is 'intentional or willful conduct designed to deceive or defraud investors . . . .' *Ernst & Ernst v. Hochfelder*, [425 U.S. 185], 199 [1976]." 51 U.S.L.W. at 5127, n.23.

Dirks thus again establishes that in the case of both primary and secondary liability under § 10(b) and Rule 10b-5, the requisite elements of a cause of action are a duty to purchasers and sellers, a conscious intent to deceive, and deception in connection with a securities transaction. Because the broker-dealer in *Dirks* had no fiduciary duty to the purchasers of Equity funding stock, and because he had not come upon his nonpublic information in an illegal or improper way, this Court concluded he had no duty to disclose the information or refrain from trading. Absent such

a duty, the broker-dealer could not be liable for aiding and abetting violations of § 10(b) and Rule 10b-5.

The Court of Appeals decision in *Harmsen v. Smith* is in clear and direct conflict with *Dirks*. Where *Dirks* holds that duty is a sine qua non of both primary and secondary liability under § 10(b) and Rule 10b-5, the Court of Appeals has concluded that in the case of aider and abettor liability, "liability exists even when the secondary violator owes no duty to the plaintiffs." (Petition, App. at 21, n.10.) In the view of the Court of Appeals, Petitioner's insistence that liability cannot be imposed in the absence of a duty to purchasers "blurs the distinction between primary and secondary violations of section 10(b)." (Petition, App. at 20.)

The "distinction" the Court of Appeals draws between primary and secondary liability, however, is inconsistent with the principle enunciated in both *Chiarella* and *Dirks*, namely, that absent a duty to purchasers and sellers of securities, the conduct of third persons is simply not governed by § 10(b) and Rule 10b-5. Moreover, the "distinction" would create two separate classes of securities law violators: (1) primary violators, who must satisfy each element for civil liability mandated by this Court in its past decisions, including "a duty to disclose" (*Dirks*), scienter (*Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976)), and causation (*Affiliated Ute Citizens v. United States*, 406 U.S. 128, 154-155 (1972)); and (2) secondary violators, whose conduct by definition does not satisfy the above three elements (or else they would be guilty of a primary violation), but who nevertheless, solely by virtue of their relationship to a primary violator and their access to nonpublic information, share equal responsibility for his violation. The "distinction" the Court of Appeals recognizes for secondary violations thus has the effect of dismantling the Court's careful explication of the requisites of liability under § 10(b),

and imposes secondary liability without such meaningful limitations on persons who have only a marginal relationship to a securities violator, and no relationship to stock purchasers or sellers. The decision is premised on the view that, even in the absence of a fiduciary relationship, if an individual has sufficient control of material information, he has a general duty to disclose that information to all persons who might be relying on the integrity of the market. It thus gives unprecedented scope and effect, in the context of secondary liability, to the "fraud on the market" theory which, it seems, cannot in any event survive this Court's recent holdings under the securities laws. See Note, *Transamerica Mortgage Advisers, Inc. v. Lewis: Implications for Private Rights of Action For Damages Under Rule 10b-5*, 1982 University of Illinois Law Review 1045, 1073.

Had the Court of Appeals recognized that secondary liability under § 10(b) and Rule 10b-5 can only arise where the person who comes into possession of material nonpublic information is an "agent" of the corporation, a "fiduciary," or a " 'person in whom the [buyers of the securities] had placed their trust and confidence,' " 51 U.S.L.W. at 5125, it would have reached an entirely different result. It is undisputed that Petitioner fit none of the preceding categories; she was neither an officer, director or employee of USNB, she did not consult in USNB's financial affairs, and she was not involved in the preparation or dissemination of annual reports, proxy statements, or other documents issued by the bank. Under these circumstances, even assuming (contrary to the District Court's own observations) that Petitioner was somehow aware USNB was somehow misleading purchasers of its stock by alleged nondisclosure of information about her loan transactions,[3] the absence of *any*

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[3] In fact, the bank's annual reports at all relevant times generally, and in the 1972 and 1973 proxy statements specifically referred to Petitioner's business transactions with USNB. See Petition at 4.

relationship with the market purchasers conclusively establishes that Petitioner's supposed knowledge did not give rise to a duty to disclose the information, and could not afford a basis for holding her liable, either directly or secondarily, for violations of § 10(b) and Rule 10b-5.

Petitioner's situation is precisely analogous to the broker-dealer in *Dirks*, though many steps removed in terms of the degree of her knowledge as well as the materiality of any knowledge she may have had. In each case, the defendant allegedly had nonpublic information indicating that a corporation was withholding information from the public. In *Dirks*, the broker-dealer had information that Equity Funding's assets were vastly overstated (by approximately $22,000,000) as the result of fraudulent corporate practices. This information was clearly material in valuing Equity Funding's stock. In the present case, Petitioner was alleged to have knowledge that USNB was "withholding" information about three loans — two fully secured totalling $221,000, one technically unsecured (originally $500,000) — notwithstanding the actual disclosure of that information. (See Petition at p. 4.) Even assuming this information was material — an untenable proposition in light of testimony by Respondents' own expert that the loans could have had no impact on the value of USNB's stock[4] — *Dirks* unequivocally establishes that Petitioner would not have been liable under § 10(b) and Rule 10b-5 had she somehow been able to capitalize on this supposed "inside information" by purchasing or selling stock. "[T]here is no general duty to forgo market transactions 'based on material, nonpublic in-

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[4]It is undisputed that the bank never lost or was threatened with risk of loss on these loans or any other transaction with Petitioner. Indeed, the FDIC, the bank's receiver, reviewed and approved all such transactions.

formation.' 455 U.S., at 233." 51 U.S.L.W. at 5128, n.27.[5]

Since Petitioner would have been free to engage in market transactions without disclosing her nonpublic information, it follows that she cannot be liable to shareholders when she did not trade, even assuming she failed to make some extraordinary effort to publicly disclose. In short, absent a duty to purchasers of USNB stock, Petitioner's possession of "nonpublic market information" (*i.e.*, the same knowledge any person has about his own transactions) simply cannot give rise to liability under § 10(b) and Rule 10b-5. The Court of Appeals' conclusion that liability for aiding and abetting can exist based solely on knowledge that a corporation is violating securities law "even when the secondary violator owes no duty to the plaintiffs" is untenable in light of the contrary decision in *Dirks*, and raises the specter that all third parties who may have access to "nonpublic information" by virtue of business dealings with the stock issuer will henceforth be exposed to liability if they fail to monitor and expose possible violations of securities law by the stock issuer. (Petition, App. at 21, fn. 10.)

Equally serious is the Court of Appeals' disregard of the scienter requirement. In *Dirks*, the Court reaffirmed that § 10(b) and Rule 10b-5 are not violated absent intentional or willful conduct specifically designed to deceive or defraud investors. Yet the District Court stated there was a complete lack of evidence that Petitioner ever knew of USNB's alleged nondisclosure. (Petition at pp. 15-16.) Petitioner's "intentional or willful" conduct was therefore apparently satisfied merely by her knowledge of her own

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[5]The nonpublic information in *Dirks* was given to the broker-dealer with the specific intention that it would result in trading. 51 U.S.L.W. at 5129. (Blackmun, J., dissenting.) As a result of the information, Dirks' customers succeeded in liquidating more than $16 million in holdings. 51 U.S.L.W. at 5124.

transactions, and her failure to detect supposedly material omissions in USNB's annual reports. Petitioner, however, was neither an officer nor director of USNB, and was under no obligation to monitor its financial disclosures. Accordingly, her "failure" to uncover minor omissions in the bank's financial statements could not be characterized as "intentional or willful" conduct without stretching the scienter requirement of Rule 10b-5 beyond recognition.

Dirks lastly confirms that liability for secondary violations of § 10(b) and Rule 10b-5 cannot exist in the absence of fraudulent conduct which artificially affects the price of the stock. 51 U.S.L.W. at 5128, n. 27. This requirement was also completely discounted by the Court of Appeals. Respondents' own expert testified that Petitioner's transactions with USNB, disclosed or not, had no measurable impact on the value of its stock, *i.e.*, were not material. Any nondisclosure of information about her loans therefore clearly did not constitute "fraud" within the meaning of the statute, and cannot support a damage award equal to the *full* loss in value of *all* stock purchased since March 1, 1971 — an amount exceeding $6,200,000.[6]

To summarize, the Court of Appeals has concluded that Petitioner is secondarily liable for violations of § 10(b) and Rule 10b-5 because she was in possession of nonpublic information of the same kind held by anyone who deals with a securities issuer, namely information about her own transactions. She neither had any reason nor any duty to monitor the bank's disclosures in this or any other respect. The Court of Appeals decision is legally insupportable, gravely unjust, and should be reversed.

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[6]It bears repeating that had Petitioner actually traded on the basis of her supposed "inside information" instead of doing nothing, her liability would have been limited to disgorging any profits thus made.

Conclusion.

For the reasons set forth in the petition, in the accompanying reply brief and the instant supplemental brief, Petitioner respectfully prays that the Court grant review in order to resolve the important issues which the Court of Appeals' decision has raised.

Respectfully submitted,

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Opposition

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QUESTIONS PRESENTED FOR REVIEW

1. Whether this Court should decide the question of aider/abettor liability under Section 10(b) of the Securities Exchange Act of 1934, in a case where such federal claims are not dispositive of the matter and where judgments for pendent state law claims will remain in effect regardless.

2. Whether the Ninth Circuit applied standards for determination of secondary liability under Section 10(b) which are entirely consistent with, and in some respects more stringent than, standards set out in prior case law.

3. Whether standing to sue is lost, retroactively, by failure to prevail at trial on the merits as to certain claims for certain periods of time.

4. Whether petitioner was afforded due process of law in all respects.

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Respondents, plaintiffs below, respectfully urge this Court to deny the petition of Helen Smith[1] for writ of certiorari. Review of this case is inappropriate in that the federal issues raised by petitioner are not dispositive of this case; pendent state claims, uniquely grounded in California law and not challenged herein, resulted in judgment against Helen Smith in excess of the federal claims. Moreover, nothing in the decision of the Ninth Circuit Court of Appeals is in conflict with other decisions of this Court or of other Courts of Appeals.

[1]Hereinafter "Helen" or "Mrs. Smith."

I

STATEMENT OF THE CASE

Petitioner Helen Smith is correct that this case does arise out of the failure of the United States National Bank. However, Mrs. Smith would have this Court believe that the only one involved in the failure of the bank was C. Arnholt Smith himself. In fact, it was overwhelmingly demonstrated at trial that Mr. Smith and a group of co-conspirators, including his wife Helen, were responsible for the losses suffered by plaintiffs in this case.

Helen attempts to paint a picture of herself as an innocent victim of technical federal securities laws. In fact, the jury found her liable for common law fraud, conspiracy to defraud, and conspiracy to abuse control, all state law claims, as well as violations of Rule 10b-5 as an aider and abettor, a control person and conspirator. The facts of this case bear directly upon the issues raised by petitioner in her claim that secondary liability was improperly imposed under Rule 10b-5. Moreover, petitioner's statement of the facts is incomplete and inadequate. Hence, a relatively extended discussion of the facts presented at trial will be set out.

A. Background of United States National Bank

In the 1950's, USNB was a small regional bank in the San Diego area. During the 1970's, the bank grew to almost a billion dollars in deposits (EXH 119). C.A. Smith had control of the bank from 1933 until the bank was declared insolvent on October 18, 1973 (RT 2443-44, 2468). At the time of the failure, the bank had loans of between $150 and $200 million dollars which were determined to be uncollectible (RT 2235-37).

Every year the shareholders of USNB received a glowing annual report that told of substantial increases in the

bank's assets and earnings (Exhibit 119 contains all of the annual reports from 1960 to 1972). Even in difficult years for most banks, USNB continued to report extraordinary earnings to its shareholders.[2]

Each report contained statements that would lead the reasonable investor to believe he or she had reached eternal success. Indeed, the very first sentence of the 1972 Annual Report stated, "we have just completed the most *successful* year in our bank's history."[3] What was not told to the investors was how the success was being achieved or who was reaping the benefits of this success.

The 1972 Annual Report was sent out in late March of 1973 to all shareholders. Notwithstanding the glowing report, USNB was closed just seven months later by the Controller of the Currency. When the bank failed, among the loans outstanding were hundreds of thousands of dollars to the individual defendants or their business entities.

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[2]The 1966 Annual Report stated "USNB recorded the highest net operating earnings in its 53-year history during the past 12 months, even though 1966 was a difficult year for the banking industry." Unfortunately for the shareholders, dividends were always paid in stock (EXH 119, 1966 Report). The 1971 Annual Report stated that USNB enjoyed one of the most profitable years in its history while other banks varied in performance (EXH 119, 1971 Report).

[3]The report detailed for the shareholder the highlights of 1972. The resources reached the billion dollar mark, their deposits and *loans* grew to first place among San Diego based banks, they expanded to include an international office, they rose from 110th to 87th among the banks in the U.S., their capital account grew nearly 50%, they increased their resources 42 percent, deposits 41 percent, and loans 35 percent. Unfortunately, they neglected to tell the shareholders to whom the loans were made (EXH 119, 1972 Annual Report, page 2).

B. How USNB Was Used by Defendants

Using shell corporations, the defendants undertook an ambitious scheme of debt rolling, self-dealing and manipulation. The bank loaned millions to controlled entities whose sole purpose was to funnel these proceeds to other corporations where they were available for the defendants' purposes (EXH 191). Frequently, the funds were applied to existing obligations to USNB; the bank thus paid itself back with its own money. In other instances, loan money went into the defendants' own personal bank accounts.

The three major entities used by the defendants were Sovereign States Capital, Inc. (SSC), British Columbia Investment Corp. (BCIC), and Westgate California Corporation (WCC).

SSC was a Smith family owned entity. The company was owned by C. A. Smith, Jr. and his wife, Jean Smith, and perhaps some others (RT 3793-95). The company dealt primarily in real estate.

BCIC dealt in real estate as well. It was purchased in 1971 by defendant M. J. Coen with a loan. He borrowed the money from SSC, which borrowed millions from USNB (RT 4296-97; EXH 191). Smith continued to manage BCIC even though Coen owned it (RT 4299), and subsequently, BCIC went under the jurisdiction of the Bankruptcy Court (RT 4341).

WCC was a major conglomerate, consisting of tuna boats, an airline, hotels, real estate, and other ventures (EXH 150). During the relevant time periods, C. A. Smith was President and Chairman of the Board of WCC. In 1970, WCC and C. A. Smith owned the controlling interest in USNB (EXH 150-B). In 1972, it was discovered that

there were millions of dollars of loans allegedly made by USNB to Westgate California Corporation, but never put on the books of Westgate (RT 4214-4215). WCC also ended up in the Bankruptcy Court.

These entities, along with their numerous subsidiaries, were Smith controlled vehicles through which millions of dollars of loans passed. It was these three entities that Helen Smith used in her transactions.

C. Helen Smith's Dealings with USNB

As her petition states, Helen is a wealthy and successful businesswoman. However, it became clear at trial that her assets came primarily from dealings with USNB, either directly or indirectly. Because of this, she now has assets in excess of $31 million, not including stock and personal assets (RT 9248-9264; 9285-9294; 9338-9352). Highlights of her transactions with USNB and related entities follow.

(1) Pueblo Lands Property

Helen Smith's first dealings with USNB were indirect and occurred in 1965, when she "invested" in real property jointly with C. A. Smith-owned entities. Although the various intermediate transactions were convoluted, the bottom line was simple: by 1973, Helen owned all the real property, the Smith-owned entities were in bankruptcy, and USNB was left with millions of dollars in uncollectible loans.

The transaction developed roughly as follows. In 1965, Helen Smith joined in a venture with Westgate California Realty (WCR), a wholly owned subsidiary of WCC. WCR purchased property in the Pueblo Lands area of San Diego

(RT 4208), using SSC as a nominee (RT 3758-60; EXH 413A). WCR had millions of dollars of fraudulent loans from USNB.

In 1971, WCR sold its interest in the land to British Columbia Investment Company (BCIC) for $500,000 (RT 4210; EXH 413B). Helen Smith herself signed the agreement and the deed to transfer one half to BCIC (RT 3761; EXH 413B). Subsequently, in 1973, the shares of BCIC were turned over to Mr. Smith (EXH 424, 425; RT 4344-4346).

Under the joint venture agreement, first WCR and later BCIC was to pay all taxes and keep the property up (EXH H.S. 41-43). In the spring of 1973, it became apparent that BCIC would be in default on millions of dollars of loans to USNB; BCIC's loans were classified since they did not have sufficient collateral (RT 3158). Loans to BCIC were brought to the attention of Mr. James Mulvaney, the President of USNB, by the national bank examiners (RT 3159). One of the loans was on the Pueblo Lands property and Mulvaney discussed it with Mr. Smith three or four months prior to the closing of the Bank (RT 3159-60).

Mr. Smith advised Mr. Mulvaney that Helen Smith had an involvement in the land, but that she would not give the bank a deed of trust as additional security. Mr. Smith personally discussed this with her (RT 3159-60). Mr. Mulvaney testified that had he known that Helen Smith was involved in the ownership of the land with BCIC, he would have considered that significant information relative to disclosure in the proxy statement (RT 3160).

On October 15, 1973, just *three days* prior to the bank being closed, Helen Smith was given a deed to the *entire*

property, on the pretext that BCIC had defaulted on its upkeep of the property (RT 3763-65; EXH 413B, C). Subsequently, BCIC went into bankruptcy, and the trustee sued Helen Smith and C. A. Smith for monies due to BCIC on the property. Helen and C. A. Smith settled the suit for $150,000 (RT 3774-77). Plaintiff's expert, Mr. David Yerke, testified that this property, as now owned by Helen Smith, has a fair market value in excess of $11,000,000 (RT 9292-93).

(2) Muirlands Vista Property

In 1966, shortly after Mrs. Smith's venture in the Pueblo Lands with WCR, she entered into an agreement directly with C. A. Smith or his son, to purchase valuable canyon property in San Diego (RT 3744-45). Above the canyon property was acreage which was purchased by SSC on October 9, 1967 (EXH 413F, G, H).

After Helen Hill married C. A. Smith in 1968, SSC sold the higher acreage to Westgate California Products (WCP) (EXH 413F, G, H). On December 30, 1970, the key lot, No. 35, was transferred to Helen Smith from WCP (EXH 413H; RT 3742-51). At the time WCP owed millions of dollars in loans to USNB.

Helen Smith received another piece of property located adjacent to the property from SSC. Mr. Smith ordered the transfer to Mrs. Smith. In the transfer request from Mr. Smith dated October 28, 1970, he requested that Lot 36 be transferred to "M.H. Alverez Hill—consideration $10.00" (EXH 430). It is curious that two years after their marriage, Mrs. Smith was still receiving property under the name of Hill. This no doubt played a part in the jury's verdict on fraud and conspiracy to defraud under state law.

Mr. Charles Kendrick testified the combined lots are now valued at $950,000 (RT 9254).

(3) Rancho Sante Fe Property

In 1967, Helen Smith entered into another joint venture with SSC to acquire property in Rancho Santa Fe (RT 3783-84). Helen Smith paid no money into the venture (RT 3786). The property was bought by SSC (RT 3786) and the deed was prepared by R. J. Sutter, the comptroller of WCC (RT 3787-88; EXH 413 D). On April 11, 1969, the property was transferred to Helen Smith (EXH 413E) on a deed prepared by D. C. Heffner (one of USNB's attorneys) and returned to Mr. Smith's office at USNB (RT 3790). The deed stated "No Tax Due", indicating that Helen paid no money for the transfer (RT 3791). The property was 12 acres with a large home on it. Mr. Kendrick testified the property is now worth $800,000 (RT 9253).

(4) International Interior Designs

Mrs. Smith also used her relationship with Mr. Smith to promote business with entities in which she was interested and which were borrowing millions from USNB.

In 1967, Helen Smith and Mr. Smith agreed that she would furnish decorating services for two new Westgate hotels. To do so, Helen formed International Interior Designs (IID). Helen's personal bookkeeper went on Westgate's payroll, except for a brief period in 1971, when she was put on IID's payroll because of an audit at Westgate. All overhead expenses were paid by Westgate, and Westgate paid for IID's personnel with its own payroll checks. Westgate paid for all Xerox costs of IID, while USNB paid for all office machinery.

Helen Smith billed Westgate $3,616,000 up through 1973. (RT 5499-5502) When the bank failed in 1973, it is estimated that Westgate or its subsidiaries had over $45 million in loans outstanding to USNB (Ex. 191).

SSC was also involved in Helen's decorating enterprise. On May 7, 1970, Westward Realty, a subsidiary of WCC, received a real estate loan of $1 million from USNB. The loan officer was C. Arnholt Smith. The $1 million was deposited in a bank account of SSC. On the *same day* SSC transferred $100,000 of the loan to IID, Helen Smith's interior decorator business. (EXH. 191-23). When asked where the $100,000 from SSC went, Helen Smith testified: "I don't know where it went." (RT 3914) On the same day IID books indicated that an *additional* sum of $50,000 was received from Westgate Plaza, a WCC subsidiary. In October, the books reflect that $100,000 was transferred to SSC and at the same time, $100,000 was received from Westgate Plaza (EXH. 412).

USNB was also directly involved with IID. Between 1971 and 1973 Helen sold the bank almost $1.2 million worth of goods and services. In 1973, the year that the bank examiners estimated that USNB had $50-$60 million in uncollectible loans, she sold the bank $794,000 in decorator good and services.[4]

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[4]The parties stipulated to the sums in the Pretrial Order (CR 1036). Mr. James Mulvaney was the president of USNB at the time of the 1973 sales. He was asked the following questions:

> Q. Mr. Mulvaney, in the last hour and a half, you have testified about the dire straits that the bank was in in 1973. You have also testified that you were not aware that furniture purchases were being made during that year in the stipulated amount of some $740 thousand dollars. In your opinion, as

(5) Loans from USNB

In 1970, Helen's business, IID, made the first direct loan from USNB. The loan was for $500,000, and was secured by certificates of deposit. The bank ledger indicated that the loan was given at 0% interest (RT 2332-33). The following year, the same loan was renewed, again at 0% interest. (EXH 415). C.A. Smith's initials appeared on the note. When questioned about these entries, Mr. Francis Banffy, from the FDIC, stated: "Well, all I can say is that these entries up here are rather unusual in this loan." (RT 2334). Mr. Banffy had felt all the transactions were unusual and could not be explained (RT 2334-39). In 1973, the loan was renewed by USNB, but this time for the amount of $375,000 at an interest rate of 9¾%. By this time, the only collateral for the loan was one certificate of

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the president of the bank, was the bank in a financial position to make those kinds of expenditures?

A. No, it was not.

Q. Did you ever see any of this furniture that was being ordered through Mrs. Smith?

A. I presume that some of the furniture was the furniture that went into furnishing the lower floors of the new building that was being built, an auxiliary building next to the U.S. National Bank Building, but that was a relatively *minor amount of furniture.*

Q. And, in your judgment, not $740 thousand dollars' worth?

A. I could not envision it being anything like that.

Q. Other than that, did you physically see where any of this furniture went?

A. No, I didn't.

Q. Do you know who authorized the acquisition of that furniture?

A. I do not. (RT 3179-3780)

deposit, in the amount of $100,000.[5] This C/D was paying to Helen Smith interest of 10½%—i.e., nearly one percent over what she had to pay for the "loan" from USNB. When asked how a loan could be extended to someone for less interest than was paid to that same individual on a C/D, Mr. Banffy answered, "I really don't know why the bank would want to pay more or could afford to pay more on a deposit than what it charges on loans." (RT 2345).

Helen Smith also arranged for USNB loans to her son, Joe Alvarez, for investments in real estate with Helen (RT 2737-38). As one example, Joe Alvarez refused to sign a statement concerning the purpose of a requested loan (RT 2738). Voler Viles, a bank officer, sent Mr. Smith an internal memo questioning the loan request (EXH 74). Mr. Smith responded by saying:

> "Dear Mr. Voler: Thank you for your note on Joe Alvarez. I talked with his mother about the matter, and she would appreciate your loaning him the money he requested and assured me she would take care of the obligation if any problem should develop.
>
> "The reason for this action is: If she loaned him the money, this would destroy the tax steps they have in mind in which Joe is purchasing a substantial amount of acreage from his mother in Borrego." (RT 2741)

As a result of the letter, Mr. Viles funded the loan (RT 2742).

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[5]The records indicate that Helen prepaid interest (RT 2336, 3633); however, the sums paid did not equal to later mentioned interest rate.

Another example is a 1973 loan to Joe Alvarez for $150,000.[6] Voler Viles thought the request was unusual, and he made a memo of same.[7] None of these loans was disclosed to the investing public (EXH 119).

D. Conclusion

Petitioner Helen Smith's primary attack upon the Ninth Circuit's decision is that secondary liability under Rule 10b-5 can result in "liability to all the world" based upon "mere silence." The facts of this case, coupled with the extremely careful instructions given by the trial court, make it clear that far more than "mere silence" was involved. Helen Smith actively, intentionally and over a course of many years exploited her relationship with C. Arnholt Smith and the bank to make profits and "deals"

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[6]It read in part:

> . . . please make a 60 day loan . . . for $150,000 to be secured by attached note. Joe's mother will be selling some stock to make a loan to him to repay this advance before maturity of loan. (EXH 78)

[7]Viles made the loan and made a confidential memo to his files on the loan. In part it read:

> "Upon further personal questioning directed to Mr. Alvarez, as to the true purpose of this second loan, he indicated that he personally was lending these funds to First California Company, Incorporated. Mr. Alvarez also requested that this purpose not be disclosed, and that collateral note, together with the corporate resolution to borrow, be retained in a confidential file to be locked in my office at all times." (EXH 79)

The credit file did not disclose the purpose of the loan (RT 2746). First California Company (FCC) was a market maker of USNB stock (RT 4289) as well as a borrower of money from USNB (EXH 169). Defendant M. J. Coen owned the controlling interest in FCC.

which would have been unavailable to any outsider. Helen Smith *stipulated* that none of these transactions was disclosed to shareholders prior to 1972. The Ninth Circuit quite correctly affirmed the judgment below.

II

REASONS REVIEW SHOULD BE DENIED

A. This is an Inappropriate Case for Determination of the Aiding and Abetting Question

Petitioner notes that this Court has not specifically determined whether aiding and abetting liability is permissible under Section 10(b) and Rule 10b-5. *Herman and MacLean v. Huddleston,* ..... U.S. ....., 74 L.Ed.2d 548, 553, n.5 (1983). Petitioner further states: "In this case, the issue is squarely presented and *is dispositive.*" (Petition, p. 9).

However, the aiding and abetting issue in this case is *not* dispositive. Helen was found responsible for control person liability within the meaning of § 20(a) of the Securities Exchange Act of 1934; petitioner does not challenge this result. More importantly, even if the judgment against Helen for all federal violations were reversed, the judgment based upon pendent state law claims would stand. As determined by the Ninth Circuit, the federal claims are certainly "not frivolous," and pendent jurisdiction may be exercised even in the event of reversal. *Anderson v. Allstate Ins. Co.,* 630 F.2d 677 (9th Cir. 1980); *Traver v. Meshiry,* 627 F.2d 934 (9th Cir. 1980).

The pendent claims in this case—for fraud, conspiracy to defraud and conspiracy to abuse control pursuant to *Jones v. H.F. Ahmanson & Co.,* 1 Cal.3d 93 (1969)—are

premised solely on state law, are not attacked in this proceeding and resulted in monetary damages in excess of the damages pursuant to the federal claims. See Ninth Circuit opinion, Appendix to Petition, pp. 4-5.

Hence, determination of the federal issues in this case by this Court would not, as a practical matter, be dispositive of the result.

B. The Ninth Circuit Did Not Expand Secondary Liability Beyond Prior Bounds

Petitioner contends that the Ninth Circuit, and the trial court below, "expanded" the concept of secondary liability, extending it to persons only "remotely connected" with securities violations and to persons whose only transgression was silence or "mere inaction." As the statement of facts, supra, makes clear, Helen must be describing someone else's case: the evidence demonstrated Helen's knowing and active participation in numerous undisclosed transactions which enriched her at the Bank's—and the shareholder's—expense. In any event, however, the Ninth Circuit's formulation of the aiding and abetting standard was entirely consistent with—indeed, even more stringent than—prior case law in this Court, in the Ninth Circuit, and in other circuits.

1. The Ninth Circuit Adopted a More Stringent Standard Than Earlier Cases.

The Ninth Circuit decision in this case incorporates the aiding and abetting standards articulated in the Second Circuit case cited in *Huddleston's* note 5, *ITT, An International Investment Trust v. Cornfeld,* 619 F.2d 909, 922 (2d Cir. 1980):

> The elements of a cause of action for aiding and abetting under section 10(b) are: (1) the existence of an independent primary wrong; (2) actual knowledge by the alleged aider and abettor of the wrong and of his or her role in furthering it; and (3) substantial assistance in the wrong.
>
> (Appendix to Petition, p. 18; citations omitted)

Moreover, the Ninth Circuit found that Helen had *actual knowledge* of C. Arnholdt's primary violations and of her role in furthering them. The Court thus did not discuss or approve the use of any relaxed *scienter* standard, such as recklessness, as was done by the Second Circuit in *IIT v. Cornfeld.*

Equally as plain, the Ninth Circuit did not (as petitioner claims) hold that "silence" with "imputed" knowledge of the primary violation was sufficient to impose liability. Rather, the Court concluded that as a matter of fact the record reflected Helen's actual knowledge and substantial assistance:

> Although Helen testified that she never discussed USNB with C. Arnholt Smith, the record shows that Helen had numerous business dealings with USNB, including transactions in which she received loans at non-market terms and acquired real property at minimal cost. There is sufficient evidence from which the jury could conclude that she knew that potential investors were being deceived by C. Arnholt. Taken in the light most favorable to the plaintiffs, the evidence also adequately supports the jury's finding that Helen knowingly provided substantial assistance in the fraud.
>
> (Appendix to Petition, p. 19)

Thus, the standards which the Ninth Circuit applied to the facts in this case are, if anything, more stringent than prior case law.

2. The Ninth Circuit Properly Determined Causation

Petitioner further contends that the aiding and abetting standard adopted by the Ninth Circuit improperly failed to limit damages to "actual damages proximately caused by the violation." Petition, p. 16. In making this argument, petitioner deliberately ignores the distinction between primary and secondary violations, and merely *assumes* the impropriety of the latter. This circular logic must be rejected.

Helen Smith, as an aider/abettor, was liable for all damages proximately caused by the violations she committed. The violations she committed involved the maintenance and encouragement of a non-disclosure policy, such that thousands of shares of worthless USNB stock were purchased by uninformed investors.

As the Ninth Circuit correctly noted, the jury was carefully—and properly—instructed that any damages awarded must be "a proximate result of the alleged misleading statements or omissions, and the purchase of stock in reliance to [sic] that." Appendix, p. 23. Further, the time periods of each defendant's liability were actually printed on the damage verdict forms. For Helen, this period was March, 1971 through October, 1973. Hence, the jury was aware of and considered the "degree of [Helen's] secondary fault" and "the actual damages attributable to it." Petition, p. 17.

C. Plaintiffs Below Had Standing to Sue Helen

The sole basis for Helen's claim that plaintiffs lacked standing to sue is the argument that because the named plaintiffs purchased stock before the period of Helen's liability as established by the jury's verdict, in hindsight they had no standing to bring suit. This reasoning contradicts fundamental jurisdictional concepts.

The Ninth Circuit quite properly rejected this argument. See Appendix to Petition, pp. 16-17:

> These plaintiffs had standing to pursue the action in the first instance. Standing ordinarily does not depend upon the merits of a plaintiff's contentions; the requirement is based upon a separate determination that the plaintiffs have made "allegations of demonstrable, particularized injury." *Warth v. Seldin*, 422 U.S 490, 508, 95 S.Ct. 2197, 2210 (1975).

Moreover, of course, Helen's contention that no "alleged acts" of hers occurred prior to purchase of USNB stock by the named plaintiffs is simply erroneous. The Pueblo Lands property transaction, the Muirlands Vista transaction and the Rancho Santa Fe transactions (discussed supra) all had their genesis in years prior to 1968. That the jury decided to limit Helen's liability to the 1971-1973 period does not affect plaintiffs' standing based upon the allegations and the evidence in the case.

D. Petitioner Was Not Denied Due Process of Law

Petitioner's claim that due process was denied her borders on the frivolous. During the six years of pretrial in this case, Helen, through her counsel, explored every possible aspect of plaintiffs' case. Exhaustive discovery was

conducted; motions for summary judgment were made and argued; interlocutory appeals were taken. A Pretrial Order comprising some 63 pages was prepared and filed several months before trial began (CR 1036). The trial judge, in a then-novel ruling, even allowed defendants the opportunity to depose various absent class members.

Nor was it necessary that the trial court formally certify a subclass of purchasers for purposes of the 10(b) claims. In its Memorandum Decision and Order dated December 23, 1976 (CR 588), the trial court considered and rejected defendants' motion for class decertification based upon the Ninth Circuit's *Harmsen I* decision. Judge Enright's analysis was clear and through, and dealt with virtually every issue now raised by petitioner. His determination that the class as certified was proper and could adequately embrace the claims involving violations of § 10(b) was both an appropriate exercise of discretion and correct under the case law governing class actions in securities cases.

Nor did the trial court commit error in refusing to admit expert testimony on materiality. In the first place, this Court has repeatedly stated that materiality issues under Rule 10b-5 "are peculiarly ones for the trier of fact." *T.S.C. Industries v. Northway, Inc.*, 426 U.S. 438, 450 (1975) Given the "reasonable investor" standard for materiality, expert testimony on it is properly excluded under F.R.E. 702. Moreover, petitioner's expert limited the scope of his testimony solely to the materiality of Helen's own transactions, rather than the materiality of the primary violations in which she participated. Hence, the testimony was properly excluded.

Petitioner Helen Smith was fully and fairly on notice of all the claims against her, and had every opportunity to defend against them both before and during trial. She received due process of law.

III

CONCLUSION

The judgments against Helen Smith were fairly obtained after fair hearing. The standards applied by the Ninth Circuit in review were proper. Most importantly, the federal questions raised by petitioner are not dispositive of the case, since the pendent state law claims are unchallenged. It is respectfully requested that the petition be denied.

DATED: July 6, 1983

Respectfully submitted,

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